

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-6144-98
NJRRichards

date: DEC 28 1998

to: Group Manager, Field Examination 1312
Southern California District
Attn: Rachel Hober, Revenue Agent

from: Southern California District Counsel (Laguna Niguel)

subject: Annual Payout Requirements of a Charitable Remainder Unitrust
Taxpayer: [REDACTED]
TIN: [REDACTED]

This memorandum is in response to your request for advice in the above referenced case.

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUES

1. Whether there are taxable consequences to the income beneficiary if a charitable remainder unitrust fails to distribute the proper annual payout.

2. Whether the charitable remainder unitrust's failure to

distribute the proper annual payout to an income beneficiary results in the revocation of the trust's status as a charitable remainder unitrust.

CONCLUSIONS

1. The trust's failure of ~~the trust~~ to distribute the proper annual payout, as set forth in the trust documents, results in a taxable deemed distribution to the income beneficiary.
2. The trust's failure of ~~the trust~~ to meet its annual payout requirement, as set forth in the trust document, does not result in the revocation of the trust's charitable unitrust status where the trust otherwise complies with I.R.C. § 664 et. seq.

FACTS

In [REDACTED], the taxpayer contributed [REDACTED] located in [REDACTED] county, to a Charitable Remainder Unitrust naming himself as the income beneficiary and the [REDACTED] as the remaindermen. The trustee, [REDACTED] is required to make an annual payout of [REDACTED] percent of the trust assets to the taxpayer.

During the [REDACTED] tax year, the taxpayer did not make an actual contribution to the trust; nor did he receive the [REDACTED] percent payout to which he was entitled. Although the trust was attempting to sell [REDACTED] during [REDACTED], it was unable to find a buyer at its asking price because of [REDACTED] in California. Thus, when the trust did not have sufficient income to cover the required [REDACTED] percent payout in [REDACTED], it did not make up the difference through the sale of its assets.

ANALYSIS

A charitable remainder trust is either a charitable remainder annuity or unitrust. The general rule for a unitrust is that its governing instrument must provide for fixed percentage payments of

The facts set forth in this opinion were obtained from your memorandum seeking District Counsel's advice and the additional facts provided during telephone conversations between Revenue Agent Hober and Mr. Richards. We have made no independent investigation of the facts in this case. Our legal conclusions are contingent on the accuracy of the information provided. Thus, Counsel reserves the right to change our conclusions if the actual facts are different than the facts represented to us in your request for advice. Accordingly, you should not rely on this memorandum, and you should seek further advice from Counsel, if you uncover any information inconsistent with the facts recited herein.

the net fair market value of the trust's assets, at least annually, to the income beneficiary. Treas. Reg. § 1.664-3(a)(1)(i)(a). The legislative history provides that the method used to determine the unitrust amount may not be discretionary with the trustee. H.R. Conf. Rep. No. 782, 91st Cong., 1st Sess. 296 (1969), 1969-3 C.B. 644, 655. The fixed percentage must be at least five percent of the fair market value of the trust assets. However, there is an income exception that allows the governing instrument to provide that the trust pay the lesser of the percentage amount or the total trust income. Treas. Reg. § 1.664-3(a)(1)(i)(b).

The legislative history is clear that the payout provisions of §§ 664 et. seq. were enacted to prevent a charitable remainder trust from being used to circumvent the current income distribution requirement imposed on private foundations. S. Rept. No. 91-552, 91st Cong., 1st Sess. (1969), 1969-3 C.B. 481. In the absence of these rules, the unitrust could abuse its tax free status by providing for a minimal payout to the income beneficiary and accumulate trust income in excess of the payout requirement without tax for the future benefit of charity. La Meres v. Commissioner, 98 T.C. 294 (1992). It is the tax free accumulation of excess income that Congress sought to prevent through the five percent, or annual trust income, requirement.

A unitrust amount may be paid in cash or other property. "In the case of a distribution made in other property, the amount paid, credited, or required to be distributed shall be considered as an amount realized by the trust from the sale or other disposition of the property." Treas. Reg. § 1.664-1(d)(5) (emphasis added). Unitrust distributions, or required distributions, have the same characteristics in the hands of the recipient as they would have in the trust. Treas. Reg. § 1.664-1(d). Thus, ordinary trust income for the taxable year and undistributed trust income from previous years is treated as ordinary income in the hands of the recipient. Treas. Reg. § 1.664-1(d)(1)(a). Likewise, capital gain for the taxable year and undistributed capital gain for previous years are treated as capital gain in the hands of the recipient. Treas. Reg. § 1.664-1(d)(1)(b). If the trust has both short and long term capital gain, the short term capital gain is deemed distributed first. Treas. Reg. § 1.664-1(d)(1)(b)(i). Finally, trust corpus, meaning the net fair market value of the trust assets less the total undistributed income in the above categories, is treated as trust corpus in the hands of the recipient. Treas. Reg. § 1.664-1(d)(1)(d).

APPLICATION

Here, the annual payout due to the taxpayer in [REDACTED] was \$[REDACTED].² However, the amount distributed to the taxpayer by the trust in [REDACTED] was \$[REDACTED]. Moreover, the trust has never distributed the remaining \$[REDACTED] to the taxpayer.

Nevertheless, the underpayment of the annual payout amount must be included in the taxpayer's [REDACTED] gross income. See, generally, Treas. Reg. §§ 1.664-1(f)(3)(iii)(b) and 1.664-(d)(4)(i). The underpayment would be created as a distribution of other property. Thus, it is treated as an amount realized by the trust from the sale or other disposition of property. See, Treas. Reg. § 1.664-1(d)(5). Therefore, the income is capital gain or a return of basis, and the taxpayer is taxed accordingly. Treas. Reg. § 1.664-(d)(1)(b).

Further, the trust should not lose its charitable remainder unitrust status if the taxpayer reports the underpayment in its gross income. The distribution will have been tax to the recipient as required. The trust will not have been used to circumvent the current income distribution requirement imposed on private foundations. Accordingly, revocation of the trust's status as charitable remainder trust is neither warranted or required.

This advice is being sent to our National Office for post-review under our nondocketed significant advice procedures. In general, we are notified of any changes to our advice with 10 business days. We will notify you of the National Office's comments upon their receipt by this office.


²Although Treasury Regulation § 1.664-3(a)(1)(i)(b) permits the taxpayer to create an income exception to the annual payout amount in the trust instrument, there is no such exception in the instrument governing the trust in this case.

We will be glad to assist you in the further development of this case. If you have any questions, please call Nicholas Richards at (949) 360-3436.


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